THE CASE FOR A GLOBAL PORTFOLIO

REGIONS
ASSET MANAGEMENT

November 2018

Executive Summary

The 2018 year-to-date underperformance of international stocks relative to domestic stocks has been noteworthy. However, the underperformance is in stark contrast to the prior year's results (see chart below). The pain of short-term underperformance has some investors questioning if a strategic allocation to international equities remains appropriate. We would answer the question with a resounding "yes".

Equity Indices	YTD as of 9/30/18	2017	2016	2015	2014	2013	2012
S&P 500 Index (Large Cap Stocks)	10.6%	21.8%	12.0%	1.4%	13.7%	32.4%	16.0%
Russell 2000 Index (Small Cap Stocks)	11.5%	14.7%	21.3%	-4.4%	4.9%	38.8%	16.4%
MSCI EAFE Index (Developed Foreign Stocks)	-1.4%	25.0%	1.0%	-0.8%	-4.9%	22.8%	17.3%
MSCI EM (Emerging Market Stocks)	-7.7%	37.3%	11.2%	-14.9%	-2.2%	-2.6%	18.2%

Source: Morningstar

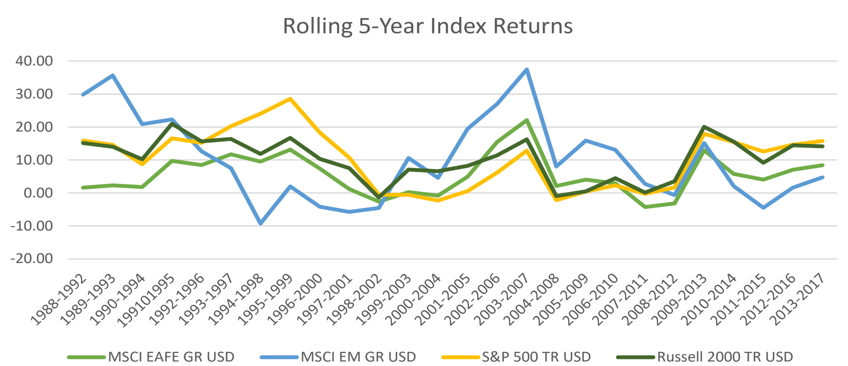
Background

When central banks around the world implemented quantitative easing (QE) in November of 2008, global equity markets overall experienced positive returns. However, since the U.S. was the first and largest economy to begin monetary easing, domestic equity markets benefitted to a greater degree than international markets. As the expansion took hold, international market returns underperformed relative to domestic markets as several international economies fell back into recession. Meanwhile, the U.S. has gone on to experience the 2nd longest economic expansion on record. Broadly speaking, this disparity of outcomes has created a more accommodative environment amongst foreign central banks nursing shorter-lived expansions relative to the Federal Open Market Committee's (FOMC) telegraphed intentions to tighten U.S. monetary policy as inflationary pressures build. We would expect international markets to experience some degree of mean reversion relative to domestic markets due to prolonged accommodative monetary policy abroad.

International Market Commentary

International equities, and especially emerging market (EM) equities, have experienced drastic swings over short time periods. In the case of EM, the opportunity cost of missing the best performing periods is significantly greater than the benefit of avoiding the worst. This high volatility, accompanied by high returns, supports establishing a strategic allocation to the asset class. The annualized return for the MSCI EM Index from 1988-2017 has been 10.44%. If an investor missed the best three performing calendar years over the past three decades, that annualized return drops to a mere 6%.

History doesn't necessarily repeat itself but often rhymes. As can be seen in the chart below, domestic and international stock performance can out/under-perform for multiple years. We expect the performance of both developed international markets and EM to play catch-up to domestic stocks over the next 10 years.



Source: Morningstar

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Looking solely at returns, exposure to international equities has weighed on portfolio performance over the past decade, with both the MSCI EAFE and EM indices returning around half the annualized return per year of the Russell 2000 and S&P 500 from 2010-2017. However, there should be other significant considerations.

1) *Diversification:* The diversification benefits from investing in a geographically diversified equity portfolio can help lower overall portfolio volatility. Correlations of the MSCI EAFE and MSCI EM indices have been low against the S&P 500 at 0.33 and 0.27, respectively, from 1988 through 2018. This diversification benefit is critical when domestic equity markets face headwinds.

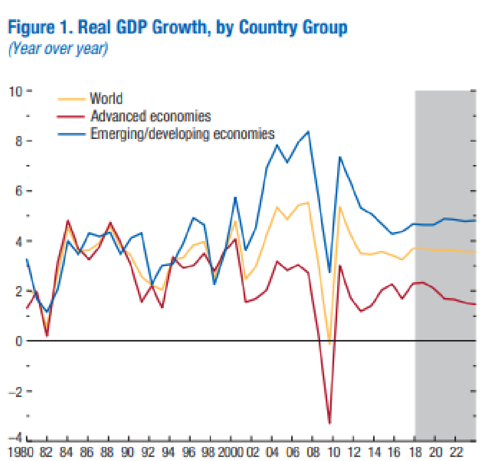
7/1/1988 -9/30/2018				
Investment	1	2	3	4
1 S&P 500 TR USD	1.00			
2 MSCI EAFE GR USD	0.33	1.00		
3 MSCI EM GR USD	0.27	0.64	1.00	
4 Russell 2000 TR USD	0.86	0.32	0.27	1.00

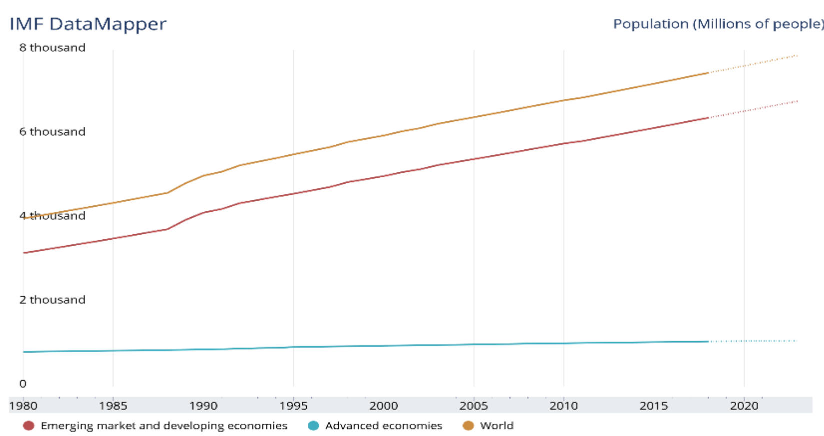
Source: Morningstar

2) *Drawdown:* From 1988-2017, a 70/30 all-domestic S&P 500/Russell 2000 portfolio experienced an average annual max drawdown of 13.84% per year, while a 50/20/20/10 broadly diversified S&P 500/Russell 2000/MSCI EAFE/MSCI EM portfolio experienced an average max drawdown of 13.47% per year. Notably, the 50/20/20/10 portfolio had a lower max drawdown in 20 of the 30 calendar years than did the domestic 70/30 portfolio. The 50/20/20/10 portfolio had a lower max drawdown every calendar year in the 1990's.

3) *Non-dollar exposure:* Relative to history, the U.S. dollar, generally speaking, is expensive primarily due to robust relative U.S. economic growth and central bank policy normalization. Many global macro managers we talk to view the U.S. dollar as one of, if not the most, over-priced currencies globally.

4) *Fundamentals:* EM markets have superior economic growth rates and demographic profiles compared to developed economies. Over time, EM markets will make up a much larger component of the global wealth distribution.





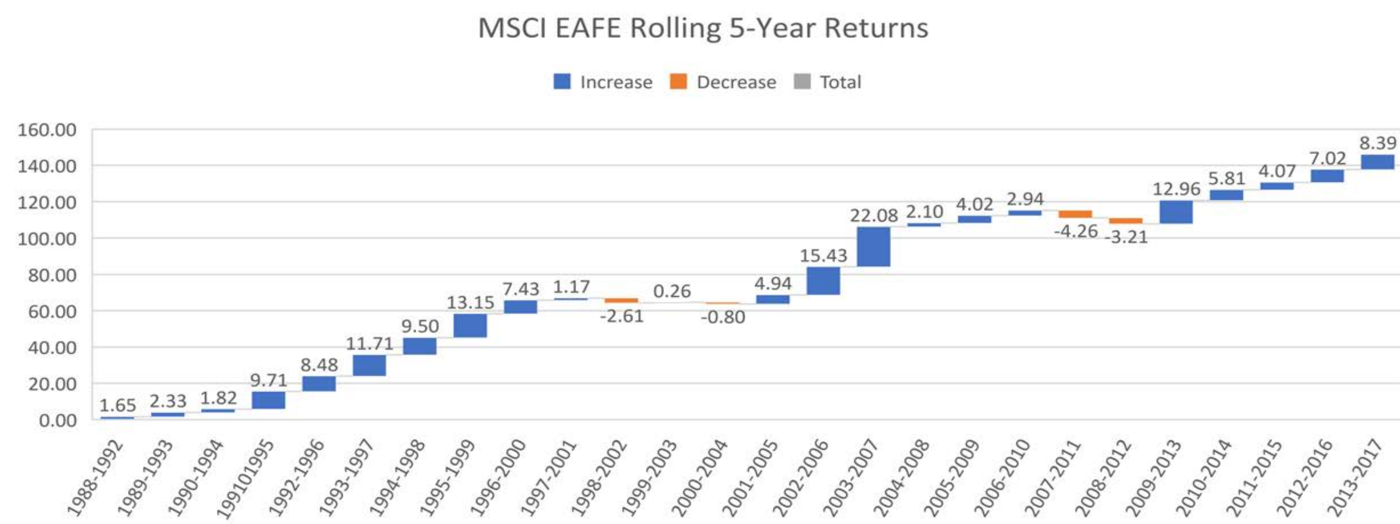
© IMF, 2018, Source: World Economic Outlook (October 2018)

International Monetary Fund, 2018. *World Economic Outlook: Challenges to Steady Growth.* Washington, DC, October.

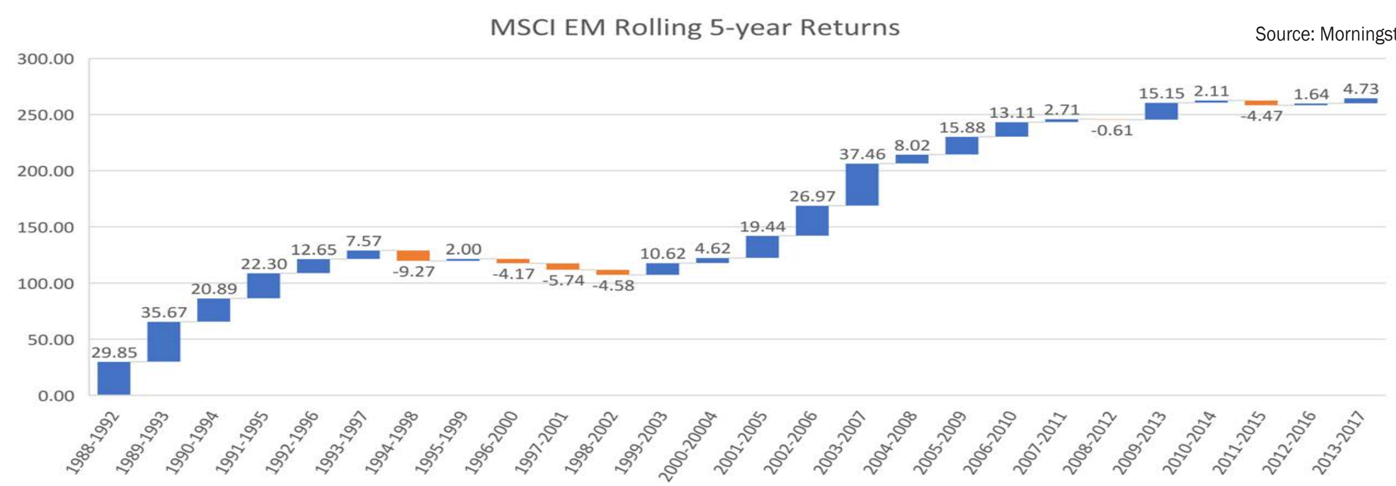
Therefore, an investor's focus should not be on returns alone but also on volatility and risk-adjusted returns. Consider since 1988 the MSCI EAFE has experienced 4 rolling 5-year time periods that were negative, while the MSCI Emerging Markets Index has experienced 6 such stretches of negative rolling returns. While EM can provide higher returns to a portfolio, this comes with additional volatility. Developed international markets tend to move in the same direction more times than not with EM, and they typically do so with lower volatility (see chart to the right). Both developed international and emerging market exposure can be additive over longer-term time horizons.

Investment	7/1/1988 9/30/2018 Std Dev (Annualized)
MSCI EAFE GR USD	21.12
MSCI EM GR USD	25.66
S&P 500 TR USD	20.83
Russell 2000 TR USD	24.20

Source: Morningstar

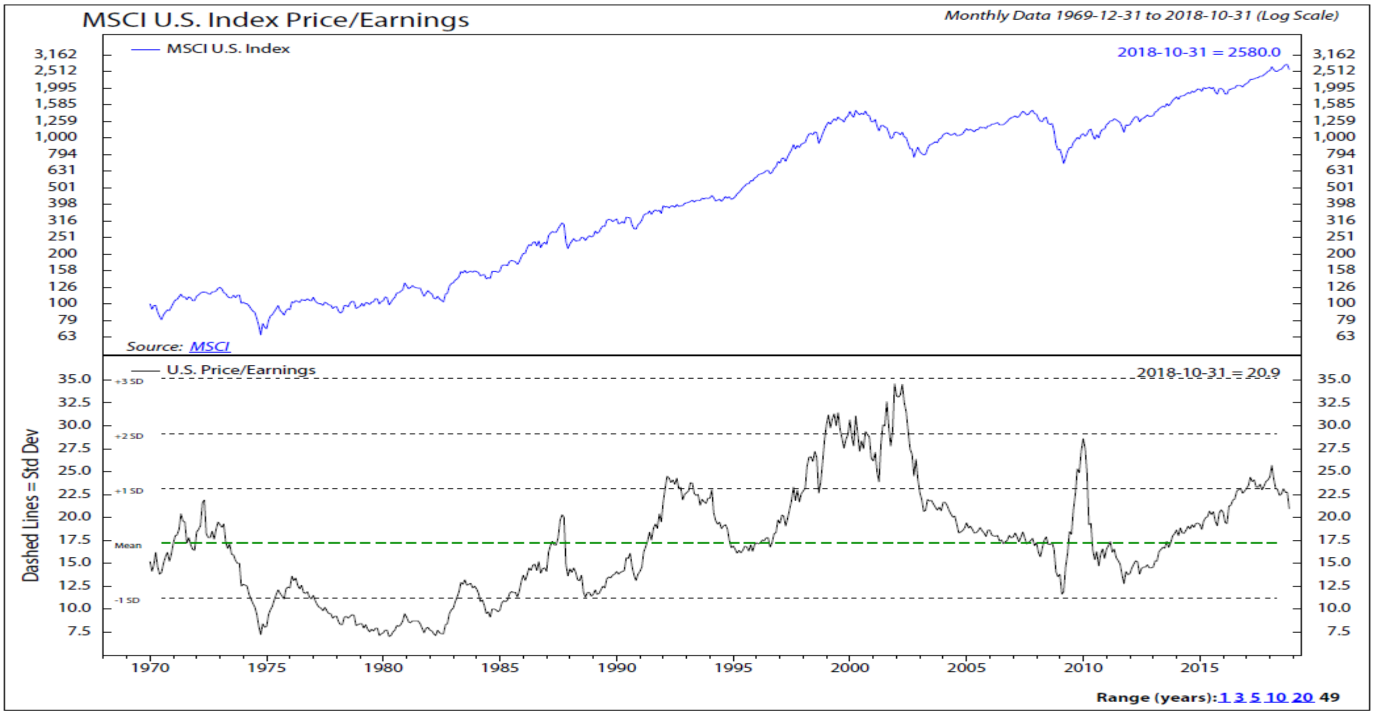


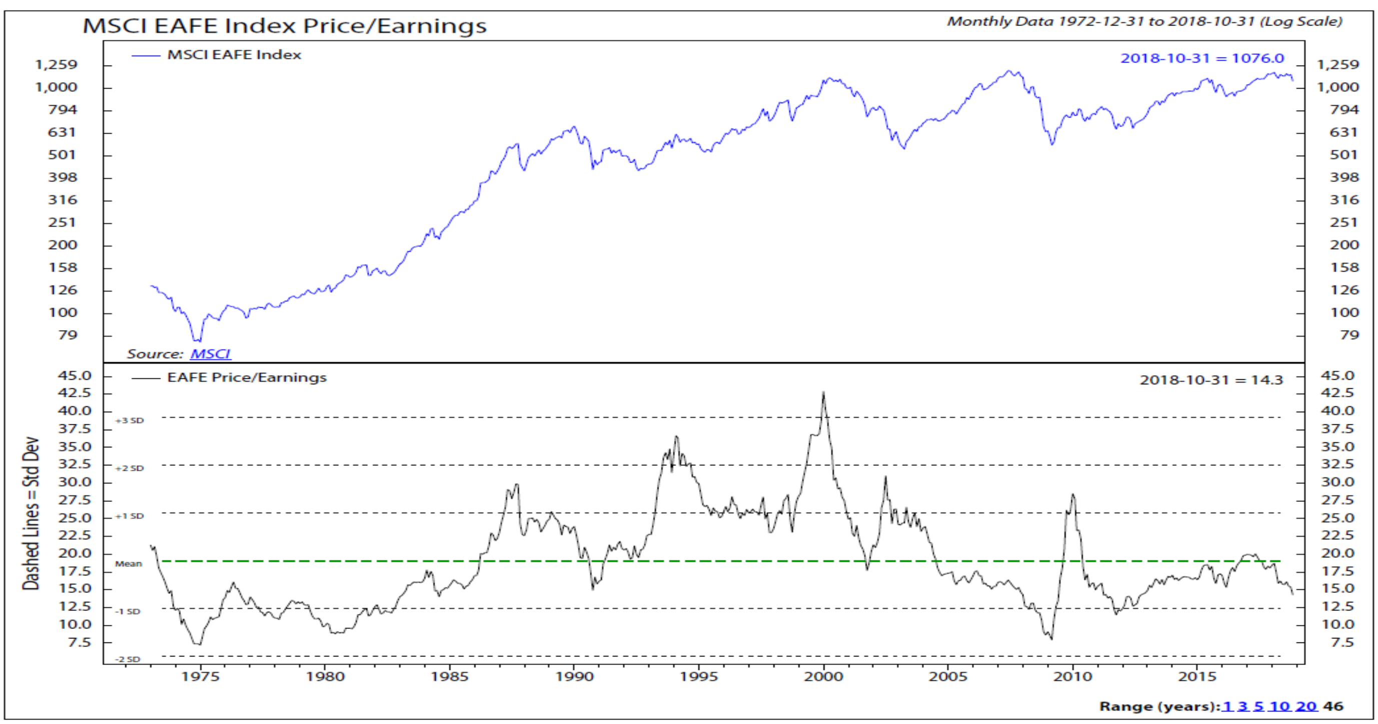
Source: Morningstar



Source: Morningstar

A final rationale favoring a strategic international stock allocation is valuation. Developed international markets have often performed better than domestic markets, as investors value earnings at different multiples at times in various regions. With the MSCI US Index trading at a P/E of 20.9x vs. a ~50-year average of 17.5x, valuations are 1 standard deviation above "normal". However, the EAFE is currently trading at 14.3x vs. its ~50-year average of 19x. We would expect some mean reversion in multiples over the next ten years. As valuation multiples drift back towards average, this should create an environment that favors international markets.





Source: Ned Davis Research

The Data

1988-2017	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
MSCI EAFE GR USD	28.59	10.80	-23.20	12.50	-11.85	32.94	8.06	11.55	6.36	2.06	20.33	27.30	-13.96	-21.21	-15.66
MSCI EM GR USD	40.43	64.96	-10.55	59.91	11.40	74.84	-7.32	-5.21	6.03	-11.59	-25.34	66.41	-30.61	-2.37	-6.00
Russell 2000 TR USD	25.02	16.26	-19.48	46.04	18.41	18.88	-1.82	28.45	16.49	22.36	-2.55	21.26	-3.02	2.49	-20.48
S&P 500 TR USD	16.61	31.69	-3.10	30.47	7.62	10.08	1.32	37.58	22.96	33.36	28.58	21.04	-9.10	-11.89	-22.10

Source: Morningstar

- The late 80's ('88-'89) saw the MSCI EM index more than double. Emerging market equities, as exhibited by the MSCI EM Index, was either the best, or second best performing index of the four in every calendar year from 1988-1993. The MSCI EM Index posted an average annual return of 40.19% during the '88-'93 time-period.
- The 1994-1999 time-period was an interesting one as the Tech Bubble was beginning to form, pushing domestic equity prices higher. From 1994-1999 the average S&P 500 yearly return was a whopping 24.14%, while the smaller-cap Russell 2000 Index posted an average annual return during that period of 14.03%. Conversely, the MSCI EAFE Index posted an average annual return of 12.61% and the MSCI EM Index posted a paltry 3.83% annual return.
- The '94-'99 time-period was a total 180 degree shift from the 1988-1993 time period as the MSCI EM Index was the worst performer of the four indices in five of the six calendar years.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Average Calendar Year Return 1988-2017
MSCI EAFE GR USD	39.17	20.70	14.02	26.86	11.63	-43.06	32.46	8.21	-11.73	17.90	23.29	-4.48	-0.39	1.00	25.62	7.86
MSCI EM GR USD	56.28	25.95	34.54	32.55	39.82	-53.18	79.02	19.20	-18.17	18.63	-2.27	-1.82	-14.60	11.19	37.75	16.33
Russell 2000 TR USD	47.25	18.33	4.55	18.37	-1.57	-33.79	27.17	26.85	-4.18	16.35	38.82	4.89	-4.41	21.31	14.65	12.10
S&P 500 TR USD	28.68	10.88	4.91	15.79	5.49	-37.00	26.46	15.06	2.11	16.00	32.39	13.69	1.38	11.96	21.83	12.16

Source: Morningstar

- From 2000-2008 the MSCI EM Index was the best performer of the four indices in six of the nine calendar years, although notably it was the worst performer of the four in two of the remaining three calendar years. The MSCI EM Index posted an average annual calendar year return of 10.78% during the '00-'08 time-period while the S&P 500 posted a -1.59% average calendar year return as significant losses during the Tech Bubble (2000-2002) and Financial Crisis (2008) weighed on returns.
- From '09-'17, both the S&P 500 and the Russell 2000 posted average calendar year returns in excess of 15%, while the MSCI EAFE and MSCI EM Indices have posted average calendar year returns of 10.2% and 14.3%, respectively. In short, quantitative easing has created a "rising tide lifts all boats" environment where all "risk" assets have moved higher, but it's apparent that QE has had a decidedly more positive effect on domestic markets than on foreign ones.

Conclusions and Recommendations

A strategic allocation to international stocks is warranted due to 1) more favorable current monetary policy conditions, 2) reversion to the mean for relative performance and valuation, and 3) diversification benefits.

While correlations of stocks typically go to 1 during times of extreme stress, as the anticipated benefits of diversification evaporate with risk-off sentiment during a crash, those draconian scenarios are limited and can be better managed via allocations to bonds and diversified strategies. Thus, a long-term focus is much more important to making sound investment decisions and maintaining discipline around a plan. The long-term data favors diversifying across geographies experiencing unique situations rather than concentrating portfolios in any singular market or country.

Source: Morningstar, IMF, Ned Davis Research

Disclosure

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